No. 92-1384

In the Supreme Court

OF THE

United States

OCTOBER TERM, 1993

BARCLAYS BANK PLC
Petitioner,

vs.

FRANCHISE TAX BOARD,
AN AGENCY OF THE STATE OF CALIFORNIA
Respondent.

On Petition for a Writ of Certiorari to the Court of Appeal of the State of California in and for the Third Appellate District

SUPPLEMENTAL BRIEF OF PETITIONER

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SUPPLEMENTAL BRIEF OF PETITIONER

This case continues squarely to present the issue of the constitutionality of worldwide combined reporting (the "unitary tax") applied to a foreign corporation or a domestic corporation with a foreign parent or foreign affiliate, an issue twice reserved by this Court in *Container Corp. of America* v. *Franchise Tax Board*, 463 U.S. 159, 189 n.26, 195 n.32 (1983). Through the nine years of this litigation and through two prior Administrations, the United States has steadfastly taken the position that such application of the unitary tax is clearly unconstitutional. Now, as part of an election year accommodation by the new Administration, the United States—while effectively admitting the unconstitutionality of the California system at issue—nonetheless points to newly enacted California legislation as ostensibly providing a complete solution. Thus, says the United States, this case no longer presents an issue of "recurring importance." This position misses the mark for the following fundamental reasons:

1. The United States' major trading partners have made it clear that they do not consider the California legislation a sufficient solution to the unitary tax problem. The nature of this problem is such that requiring another case to wend its way through the courts, for the number of years which these complex cases take, risks the very retaliation that the foreign Commerce Clause seeks to avoid.

2. The issue presented here is of great importance to the international community and to the affected taxpayers because it involves $1 billion in taxes and fees already collected or to be collected under the admittedly unconstitutional California tax scheme. It is unfair—and disruptive of foreign relations—to allow the State of California to retain monies collected in violation of the Constitution. Moreover, by the very nature of the audit process, past tax years will continue to be the subject of future audits and assessments well into the next century, with the same potential for continuing foreign offense that has already caused the United States to conclude that the application of the system is unconstitutional.

3. The issue is of further recurring importance because at least six other states apply worldwide combined reporting in whole or in part. With the open invitation that the California Supreme Court opinion constitutes, it is highly likely that addi-

tional states will adopt this unconstitutional tax method, absent intervention by this Court.

4. Finally, by its very nature and for all of the above reasons, this issue requires a national solution now rather than a piecemeal state response. The United States itself has previously acknowledged to this Court that a uniform national solution is required. The new California legislation does not provide that.

STATEMENT

This case does not arise under a tax system "that no longer exists." Am. U.S. Br. No. 92-1384 at 8. California has not abandoned worldwide combined reporting which is and will remain its basic tax system. Six other states use worldwide combined reporting in whole or in part. Idaho, Montana and North Dakota use this as their basic system and Alaska (oil and oil pipeline companies) and Tennessee (financial institutions) mandate its use for special industries.[1]

This case is designated by Respondent as the determinant case on the constitutionality of worldwide combined reporting under the "one voice" test. Pet. App. I.[2] This case involves $500 million of refunds of taxes already collected under worldwide combined reporting and $350 million to $400 million of taxes to be collected. Pet. Supp. App. L p. A22. Refunds of fees paid for the "privilege" of electing out of worldwide combined reporting also rest on a determination of the system's constitutionality. Pet. Supp. App. M.

Even if all eligible taxpayers elect the new alternative in 1995,[3] California will continue to assess taxes under worldwide combined reporting under the usual audit cycles well into the next century.

[1]Utah permits elective worldwide combined reporting with a mandatory water's edge system.

[2] All references to the appendices in this supplemental brief are denominated "Pet. Supp. App." followed by the letter of each item. All references to the appendices in the Petition for Certiorari are denominated "Pet. App." Petitioner's Rule 29.1 statement is included in the Petition for Certiorari at 2-3 and Pet. App. G.

[3] The alternative is first applicable to years beginning on or after January 1, 1994. A taxpayer elects on the filing of its tax return for the first year of election. Cal. Rev. & Tax. Code § 25111.

Neither the United States nor foreign nations found California's 1986 water's edge legislation, first effective in 1988, sufficient to resolve controversy over worldwide combined reporting. Both before and after the enactment foreign governments and the United States continued to express concern over use by California and other states of worldwide combined reporting.

On September 10, 1993, the California Legislature amended California's earlier enacted alternative to its basic worldwide combined reporting taxation system (Senate Bill 671, Supp. Br. Resp. App. A) for two reasons: 1) to avoid the immediate threat of British retaliation; and 2) to make it possible for the Clinton Administration to file a "neutral" brief with the Supreme Court with respect to whether the Court should grant certiorari in this very case:

> The prior Administration had filed a brief with the Supreme Court on behalf of Barclays. But as a presidential candidate, Clinton assured California officials that he would side with the states on the issue.
>
> The threat of retaliation, however, naturally caused a seriously awkward situation for the new Administration, and Treasury representatives have requested that California's law be modified to remove the threat. California officials have been assured that if our law is changed in a manner which will remove the threat, then a neutral brief (to the effect that the Administration does not advise the Court to take up the *Barclays* case) would be filed.

Cal. Legislative Comm. Report on Senate Bill 671 (Pet. Supp. App. L p. A26).

In Senate Bill 671 the California Legislature also provided for tax *relief* for *California* businesses at a net cost to the state of over $2.3 billion dollars during the next seven years. Pet. Supp. App. L p. A22.

A number of recent events not mentioned by the United States in its brief are important to this Court's decision whether to grant review.

a. On May 13, 1993, the Chancellor of the Exchequer of the United Kingdom, in response to a Parliamentary Question, stated that he had informed United States Secretary of Treasury Bentsen: "[T]hat the Government will have to take retaliatory measures in relation to United States based companies if there is not a satisfactory resolution of the problem of the internationally-opposed unitary tax on foreign-owned companies in California by the end of this year." Pet. Supp. App. N p. A35.

b. In June, 1993, the Finance Committee of the German Bundestag issued a Resolution requesting the German Government to take immediate steps to consider the application of retaliatory measures should it prove impossible to achieve a satisfactory solution to the problem of unitary taxation within a reasonable time. Pet. Supp. App. O pp. A36-A37.

c. On September 15, 1993, the Chancellor of the Exchequer of the United Kingdom announced that, even after passage of Senate Bill 671, defects remained in California's law. The United Kingdom would defer retaliatory action and would retaliate "only if it is found that the [newly enacted California] legislation is being applied in a way which exposes UK owned companies to damage from taxation that is inconsistent with the arm's length principle." However, the Chancellor went on to state:

> While the legislation in California is a significant step forward, on its own it does not provide a complete solution to the unitary tax problem. For a complete solution it will be necessary to have the internationally accepted arm's length principle endorsed, on a permanent basis, as the only valid method of taxing foreign companies in any State. Success for the Barclays case in the Supreme Court would achieve this. The Government will continue strongly to support Barclays' case. I hope it will succeed. If it does not, the UK will have to retain its retaliatory powers in reserve as a barrier against the possibility that States might damage UK owned companies by the imposition of unitary taxation at some time in the future.

Pet. Supp. App. P p. A38.

d. On September 23, 1993, the Member States of the European Community and the Commission of the European Communities sent a diplomatic note to the State Department:

> While this legislation is an improvement, the Member States and the European Commission do not consider that the unitary tax problem is solved. Worldwide unitary taxation, which is contrary to the internationally agreed arm's length principle, is still the basis of the tax system in California. A complete solution will require the arm's length principle to be established as the only legitimate basis of taxing foreign companies in any state.

Pet. Supp. App. Q p. A40.

ARGUMENT

I.

This Case Presents A Substantial And Recurring Question Of Great Constitutional Importance And International Concern.

The United States concedes that the application of worldwide combined reporting to divide the international income of foreign owned groups violates the Commerce Clause. Thus the substantial amount of taxes already collected and yet to be collected under this unconstitutional scheme and substantial fees collected and to be collected from taxpayers for the "privilege" of avoiding the unconstitutional taxing scheme — probably totalling one billion dollars — are a continuing and recurring constitutional violation of great significance. This case is not moot.

The issue presented by this case has been of major and mounting concern for over 20 years. Twenty nations have filed amici curiae briefs in support of this petition for certiorari, in search of a national — not a California — resolution. These nations have consistently protested any state's use of this system which conflicts with the international standard of arm's length separate accounting. Twice the United Kingdom has taken more formal retaliatory steps (the second in the last few months, *see* Pet. Supp. App. N). The Finance Committee of the German Bundestag has also urged consideration of retaliation.[4] Pet. App. Supp. O p. A37. Nations perceive this case as providing such a

[4]This request has not been rescinded.

national solution. Pet. Supp. App. P p. A38, App. Q p. A40. They do not so perceive the California legislation. *Id.*

California makes no provision for return of amounts seen by both foreign governments and the United States as improperly collected. The legislation modifying its tax system has an avowed purpose of avoiding a decision in this case in order to keep taxes collected. Pet. Supp. App. L pp. A25-A27.[5] Such actions violate a fundamental sense of fairness. In areas which affect foreign relations, such incidents lead to harm to the Nation: "Experience has shown that international controversies of the gravest moment, sometimes even leading to war, may arise from real or imagined wrongs to another's subjects inflicted, or permitted, by a government." *Hines v. Davidowitz,* 312 U.S. 52, 64 (1941); *Chy Lung v. Freeman,* 92 U.S. 275, 279-80 (1875). Resolution now, particularly where this case concerns not imagined wrongs but constitutionally matured rights (*see Dennis v. Higgins,* 498 U.S. 439, 448 (1990)) is clearly necessary to avoid any further harm to this Nation's international relations.

Because the new legislation applies only to years beginning in 1994, the State will continue to impose its compulsory worldwide combined reporting system on all taxpayers that have income years open for assessment. Normal audit and assessment cycles extend that process well into the next century. This ongoing application of mandatory worldwide combined reporting to foreign unitary groups will continue foreign offense and the implication of United States foreign policy long after the new California legislation becomes effective.

The United States begrudgingly admits that California's prospective water's edge alternative does not conform to the international standard.[6] The constitutionality of combination of a foreign

[5]Lest there be concern over the effect on the State of an obligation to return or forebear collection of the sums at issue, the newly enacted California law provides for $2.3 billion of tax relief for California business over the next seven years. Pet. Supp. App. L p. A22.

[6]For example, once a foreign corporation crosses the California 20 percent threshold (20 percent of the average of its property, payroll and sales in the United States) 100 percent of its income is in the water's edge. Under the international standard, only that income from the permanent establishment in the United States is included, never the

parent or a foreign affiliate doing business in the United States is one of the questions reserved in *Container,* is now before this Court in this case and continues to be an issue even under the new California legislation. Further, the water's edge election continues to impose discriminatory burdens on electing taxpayers.[7]

The United States completely omits any reference to the other six states that use worldwide combined reporting. The United States also assumes that no other state will adopt the system in the future.[8] In the early 1970's when this issue began, only three states (California, Oregon and Alaska) utilized worldwide combined reporting. In addition to the states now using worldwide combination, other states employ "domestic" combined reporting but may include unitary foreign corporations doing business in the United States in the combined report on a worldwide basis.[9]

If this Court fails to determine this case now, there is no barrier to any state adopting worldwide combined reporting. In fact the decision of the California Supreme Court stands as an encourage-

entire income of the corporation. Respondent has also rejected federal and treaty limitations on the source of income of such a foreign corporation, another nonconformity. *See* Cal. Code Regs. tit. 18, §§ 25110(d)(2)(G)(i) and (ii) (1992).

[7]To elect a taxpayer must agree to include dividends received from "significant" (15%) suppliers and customers in its California tax base. Cal. Rev. & Tax. Code § 25110(b)(2)(B)(ii); *compare Allied-Signal, Inc. v. Director, Div. of Taxation,* 357 U.S. 28 (1992). *See also Kraft Gen. Foods, Inc. v. Iowa Dep't of Revenue and Fin.,* ____ U.S. ____, 112 S. Ct. 2365 (1992). Taxpayers also face immediate tax on otherwise deferred offshore intercompany transactions not in the water's edge when they elect. How the legislation will be applied, particularly with respect to compliance burdens, remains of concern. Compliance burdens associated with worldwide combined reporting are an ongoing source of international irritation and their constitutionality is a separate issue in this case.

[8]Future adoption which compounds proliferation is a constitutionally significant concern. *See Japan Line, Ltd. v. County of Los Angeles,* 441 U.S. 434, 453 (1979).

[9]Arizona, Illinois, New Hampshire and New Mexico.

ment to do just that.[10] The United Kingdom is retaining its retaliatory legislation against this possibility. Pet. Supp. App. P.

II.

This Case Involves An Issue Of An International Standard. Only The Nation, Not A State, Can Provide A National Solution.

In its second argument the United States posits the unique contention that national regulation of foreign commerce is well served by a single state's unilateral determination of an acceptable prospective alternative to its basic and constitutionally violative system. This argument is completely contrary to the purposes and policies animating the dormant foreign Commerce Clause.

As this Court has said:

> The few simple words of the Commerce Clause . . . reflected a central concern of the Framers that was an immediate reason for calling the Constitutional Convention: the conviction that in order to succeed, the new Union would have to avoid the tendencies toward economic Balkanization that had plagued relations among the Colonies and later among the States under the Articles of Confederation.

Hughes v. Oklahoma, 441 U.S. 322, 325-326 (1979). *See also Wardair Canada, Inc. v. Florida Dep't of Revenue*, 477 U.S. 1, 7-8 (1986). To propose that a state determine how it will resolve its use of an international tax system clearly inconsistent and incompatible with that used by both the United States and its trading partners invites exactly the economic Balkanization feared by the Framers. Who is the "voice of the United States" among this babble of the states? Are North Dakota and Tennessee now to be invited to propose their solutions?

The United States had it right the last time:

> The Commerce Clause recognizes that there are matters affecting our foreign commercial relations that inherently require a national solution so that the United States may speak with one voice in its dealings with other Nations. That Congress has not yet crafted a solution to the problem does not mean that the choice of solutions has been left to the separate action of the several States. *See Container Corp. v. Franchise Tax Board*, 463 U.S. at 194.

Am. U.S. Br. No. 92-212 (Pet. Supp. App. K p. A15).

The Member States of the European Community have already informed the United States that a "California solution" is insufficient. They rightfully continue to seek a solution from the Nation, not a piecemeal approach by the states. Pet. Supp. App. Q. Acceptable variations to the international standard are questions to be agreed upon by nations, not unilaterally adopted, even with the United States Executive's blessing, by a state.

The United States' argument has familiar resonances:

> The Solicitor General, as *amicus curiae*, says that the Government does not "contend that the application of the Oregon escheat statute in the circumstances of this case unduly interferes with the United States' conduct of foreign relations." But that is not the point. We deal here with the basic allocation of power between the States and the Nation. Resolution of so fundamental a constitutional issue cannot vary from day to day with the shifting winds at the State Department. Today, we are told, Oregon's statute does not conflict with the national interest. Tomorrow it may. But, however that may be, the fact remains that the conduct of our foreign affairs is entrusted under the Constitution to the National Government, not to the probate courts of the several States.

Zschernig v. Miller, 389 U.S. 429, 443 (1968) (Stewart, J., concurring).

III.

California's Legislation Provides No Accommodation Of The Affected Interests.

The United States mysteriously hints that further review of this case could "potentially destabilize" an "accommodation" of state, national and international interests reached on this issue.

There is no accommodation of the foreign taxpayers' interest in one billion dollars of back taxes and assessments which stand to

[10]The California Supreme Court's opinion created a new test for congressional acquiescence to state action in Congress' failure to act while "aware" of the problem from its reading of a "trend" in this Court's decisions. *Compare* Pet. App. C with App. A and App. B. The lower California courts had found no such "trend." State courts struggling with the issues of federal/state relations need guidance from this Court on the proper application of this Court's decisions.

be collected under an unconstitutional taxing scheme. There is a continuing constitutional violation.

There is no accommodation reached with the foreign governments. The trading partners of the United States continue to request a national solution.

And the Constitution does not "accommodate" the state[11] in the sensitive area of foreign affairs and commerce:

> For local interests the several States of the Union exist, but for national purposes, embracing our relations with foreign nations, we are but one people, one nation, one power.

The Chinese Exclusion Case, 130 U.S. 581, 606 (1889).

At stake here is sixty years of cooperation among nations to achieve a uniform national response to the division of income for tax purposes among such nations. "Destabilization" will occur only if this Court fails to take this case.

The application of worldwide combined reporting by states of this Nation to foreign multinationals for the past twenty years has led this Nation to the brink of a trade war. It has taken the Petitioner nine years to move this case through the California court system. The case is fully justiciable. The issue is ripe. This Court should provide a national solution here and now.

Respectfully submitted,

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[11]The federal/state accommodation seems to permit the State to keep the one billion dollars at issue here in taxes and fees while providing $2.3 billion of tax relief to California companies.

Appendix K

No. 92-212

In the Supreme Court of the United States

OCTOBER TERM, 1992

BARCLAYS BANK PLC, PETITIONER

v.

FRANCHISE TAX BOARD, AN AGENCY OF THE STATE OF CALIFORNIA

ON PETITION FOR A WRIT OF CERTIORARI TO THE SUPREME COURT OF THE STATE OF CALIFORNIA

BRIEF FOR THE UNITED STATES AS AMICUS CURIAE
IN SUPPORT OF PETITIONER

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QUESTION PRESENTED

Whether, as applied (i) to a domestic corporation that has a foreign parent or (ii) to a foreign corporation that has a foreign parent or foreign subsidiaries, California's use of the worldwide formula apportionment method to allocate income for tax purposes violates the Commerce Clause of the Constitution.

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v.

FRANCHISE TAX BOARD, AN AGENCY OF THE STATE OF CALIFORNIA

ON PETITION FOR A WRIT OF CERTIORARI TO THE SUPREME COURT OF THE STATE OF CALIFORNIA

BRIEF FOR THE UNITED STATES AS AMICUS CURIAE IN SUPPORT OF PETITIONER

INTEREST OF THE UNITED STATES

The Constitution confers upon Congress the power to "regulate Commerce with foreign Nations" (Art. I, § 8, Cl. 3) and authorizes the President, "by and with the Advice and Consent of the Senate, to make Treaties" (Art. II, § 2, Cl. 2). The United States has a substantial interest in cases that address the constitutional allocation of authority over matters affecting foreign commerce and foreign relations. This case presents such an issue.

As this Court recognized in *Container Corp. v. Franchise Tax Board*, 463 U.S. 159, 184-193 (1983), the United States employs the arm's length method for allocating income among commonly controlled corporations. This method, which reflects the consistent practice of all major trading Nations, is also required, for federal taxation, by numerous tax treaties to which the United States is a party. California's use of the worldwide combined reporting method for allocating income among a unitary group of multinational corporations conflicts with this uniform international practice and has created an irritant in the commercial relations of the United States and its major trading partners. The Departments of State and Treasury inform us that foreign governments have objected to California's departure from accepted international tax practice and have threatened (or enacted)

retaliatory legislation against United States corporations as a result of California's unilateral actions. The State's tax has thus seriously undermined the federal government's ability to "speak with one voice when regulating commercial relations with foreign governments." *Michelin Tire Corp.* v. *Wages*, 423 U.S. 276, 285 (1976).

STATEMENT

1. Two different methods have been used to identify and allocate among taxing jurisdictions the income received by multinational corporations. The method employed by the United States is known as the "separate accounting" or "arm's length" method. This method generally treats each corporation as a distinct tax unit, doing business with every other corporation (including its parent, subsidiaries or affiliates) on an arm's length basis. The separate accounting method of taxation is employed in the Internal Revenue Code and is a central feature of the many bilateral tax treaties to which the United States is a party (Pet. App. F44). The separate accounting method is also the accepted international standard.[1] It is almost universally applied by foreign tax systems and has been incorporated in the model tax treaties adopted by the United Nations and the Organization for Economic Cooperation and Development (*ibid*).[2]

[1]The international practice is described in the letter to Governor Deukmejian of California, dated January 30, 1986, from Secretary of State George P. Shultz (Pet. App. F44-F46). See also G. Maisto, *General Report*, in 77a *International Fiscal Ass'n, Cahiers de droit fiscal international (Transfer Pricing in the Absence of Comparable Market Prices)* 19-75 (1922). Maisto notes that the arm's-length method is the primary method for allocating income internationally and that the OECD considers the combined reporting and formula apportionment method of allocating income to be arbitrary. *Id.* at 50-51. Other than in a few States of the United States, the worldwide combined reporting method is not used at the national or sub-national level by the United States or any of its major trading partners or in any of the countries surveyed. *Ibid.*

[2]See OECD Model Double Taxation Convention on Income and on Capital, Art. 7 (1977); Organization for Economic Cooperation and Development Committee on Fiscal Affairs, *Transfer Pricing and Multinational Enterprises* (1979); United Nations Model Double Taxation Convention Between Developed and Developing Countries, U.N. Pub. No. ST/ESA/102, Art. 7 (1980).

The other method of allocating corporate income among taxing jurisdictions is the "worldwide combined reporting" method used by California and two other States. For corporations engaged in a unitary business, California ignores the separate corporate existence of parents, subsidiaries and affiliates, pools their income together, and allocates a portion of that combined income to California based upon a multi-factor apportionment formula.[3] See *Container Corp.* v. *Franchise Tax Board,* 463 U.S. 159, 162-163 (1983). California applies its worldwide combined reporting method not only to domestic parent corporations that have foreign subsidiaries (see *ibid.*) but also to domestic subsidiaries (conducting business in California) that have foreign parents and to foreign parents (conducting business in California) that have foreign subsidiaries.

California's application of the worldwide combined reporting method of taxation to corporations doing business in California that have foreign parents or foreign affiliates conflicts with the "separate accounting" method applied under federal law and under established international practice. In letters addressed to the governors of the six States that then employed the worldwide combined reporting method of taxation. (Alaska, California, Idaho, Montana, New Hampshire and North Dakota), the Secretary of State expressed the concern of the United States that state use of worldwide combined reporting "is at odds with the position of the United States and has become a source of conflict with foreign states" (Pet. App. F45). The Ambassadors of Australia, Belgium, Canada, Denmark, France, the Federal Republic of

[3]Under the three-factor apportionment formula used by California, the in-state corporation's income is calculated as a percentage of the total income of the group of related corporations. After the unitary business group is identified, the in-state corporation's sales, property, and payroll are expressed as a fraction of the total sales, property, and payroll of the unitary group. These three fractions are arithmetically averaged. This average is then multiplied against worldwide group income to yield the taxable income of the in-state corporation (Pet. App. A5).

Germany, the United Kingdom, Greece, Ireland, Italy, Japan, Luxembourg, the Netherlands and Switzerland have advised the United States that the worldwide combined reporting method of taxation constitutes "a serious obstacle to the further development of our trade and investment relationships" (Pet. App. F45). In particular, the United Kingdom enacted legislation in 1985 that provides for retaliatory tax treatment of United States corporations that operate in the States that apply the worldwide combined reporting method.[4] While the United Kingdom has not yet invoked this legislation,[5] its enactment provides clear indication of the adverse impact that California's method of taxation has on the conduct of foreign economic relations by the United States.

2. The taxpayers involved in this case are Barclays Bank International Limited (BBI) and Barclays Bank of California (Barcal). During 1977, Barcal (a United States corporation conducting banking activities in California) was a wholly owned subsidiary of BBI (a United Kingdom corporation conducting an international banking business).[6] Both BBI and Barcal did business in California and were therefore subject to tax in that State (Pet. 3, 4; Pet. App. C36-C38).

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[4]The United Kingdom legislation denies tax credits on the taxes owed by such corporations for dividends they receive from their United Kingdom subsidiaries. See Finance Act 1985, Pt. II, ch. I, § 54, and Sch. 13, ¶ 5 (Eng.), reenacted without substantial change in Income and Corporation Taxes Act 1988, Pt. XVIII, ch. III, § 812 and Sch. 30, ¶¶ 20 and 21 (Eng.). See also Parliamentary Debates (Hansard) 1014-1018 (10 July 1985); Secretary of State Shultz's letter to Governor Deukmejian (Pet. App. F46).

[5]The United Kingdom has stated that the legislation will not apply to dividends paid on or before December 31, 1989. See Joint Report by Inland Revenue and U.S. Treasury, *Unitary Tax: Review of Progress Towards Resolving the Problems*, para. 6.2 (Dec. 1991).

[6]BBI was a wholly owned subsidiary of Barclays Bank Limited, a United Kingdom corporation. In 1982, Barclays Bank Limited changed its name to Barclays Bank PLC, which is named as the petitioner in this case (Pet. 2-3).)

In computing its California income tax for 1977, Barcal used the separate accounting method and reported only the income it earned from California sources. In computing its California income tax for 1977, BBI reported not only the income it earned from California sources but also included (i) income BBI earned from operating bank agencies and branches in the United Kingdom and approximately 33 nations or territories outside of the United Kingdom and (ii) the income earned by 70 subsidiaries (including Barcal) of BBI operating in 34 nations or territories outside of the United Kingdom. BBI did not, however, include the income of BBI's parent (see note 6, *supra*) or of the parent's subsidiaries. Thus, neither Barcal nor BI submitted its California tax return under the worldwide combined reporting method required by California (Pet. 7-8; Pet. App. C38-C41).

The California Franchise Tax Board determined that Barcal and BBI were members of a worldwide unitary business conducted by all members of the Barclays Group. That Group included (i) Barcal, a wholly owned subsidiary of BBI doing business only in California; (ii) BBI, A United Kingdom Corporation doing general retail and commercial banking in the United Kingdom and 34 other nations or territories outside the United Kingdom, including California; (iii) the subsidiaries of BBI in which BBI has more than a 50% interest; (iv) Barclays Bank Limited, a United Kingdom corporation which conducts no business in California and which owns 100% of the stock of BBI; and (v) the subsidiaries of Barclays Bank Limited in which that corporation holds more than a 50% interest. The California Franchise Tax Board calculated the tax owed by BBI and Barcal by allocating a portion of the total income of the above unitary group to these two taxpayers utilizing a three-factor apportionment formula. The State's calculation indicated a tax deficiency, which the Board then assessed (Pet. 7-8; Pet. App. C38-C40).

3. Barcal and BBI challenged the State's assessment because it was based not only on the income that they had separately earned but also on the income of their foreign parent and other related foreign subsidiaries which do no business in California or elsewhere in the United States. After paying the assessments, the taxpayers sued for a refund in California superior court (Pet. App. C38-C41).

The trial court entered judgment in favor of the taxpayers (Pet. App. C1-C34). The court concluded that California's computation of taxes by use of worldwide combined reporting improperly included income earned by foreign parents and affiliates of the taxpayers. The court held that this violated the Commerce Clause of the United States Constitution because it impeded the federal government's ability to speak with one voice in the conduct of foreign affairs (*id.* at C23-C26), impermissibly discriminated against foreign commerce (*id.* at C26-C28) and violated due process (*id.* at C29-C30).[7]

The California court of appeal affirmed (Pet. App. B1-B37). The appellate court held that California's application of worldwide combined reporting to the income received by foreign parents and affiliates of the taxpayers violated the Commerce Clause because it frustrated the United States' ability to speak with one voice in an area of foreign affairs where federal uniformity is necessary (*id.* at B35).

The California Supreme Court reversed, upholding the constitutionality of the tax under the Commerce Clause as applied in this case. The court relied extensively on the fact that, while Congress has been given many opportunities, it has not enacted legislation to prohibit the States from employing the worldwide combined reporting method to multinational corporations (Pet. App. A28-A31). Concluding from "the din" of this legislative "silence" that Congress "has decided *not* to prohibit state use" of worldwide combined reporting "in cases of this kind" (*id.* at A26), the court declined to apply the Commerce Clause to prohibit the State from enforcing a tax that Congress has not acted affirmatively to prohibit (*id.* at A24-A38).

Since the court of appeal had resolved the case solely under the Commerce Clause, and had not reached petitioner's separate due process challenge to the State's tax (see note 7, *supra*), the

[7]The trial court concluded that procedures adopted to implement the State's worldwide combined reporting method violate due process because, "with customarily and currently available acounting [sic] data, literal compliance with [their] requirements is impossible for foreign multi-nationals" (Pet. App. C29).

California Supreme Court remanded the case to the court of appeal for further proceedings on that issue (*id.* at A39-A40).

ARGUMENT

In *Container Corp.* v. *Franchise Tax Board,* 463 U.S. 159 (1983), the Court held that California's use of the worldwide combined reporting method for allocating the income of a unitary business did not violate the Commerce Clause. *Id.* at 184-197. That case, however, concerned application of the worldwide combined reporting method to a domestic parent corporation doing business in California. Recognizing the potentially different and additional considerations involved when the incidence of a state tax falls on a *foreign* corporation, the Court expressly reserved the question whether the California method would be constitutional "with respect to state taxation of domestic corporations with foreign parents or foreign corporations with either foreign parents or foreign subsidiaries." *Id.* at 189 n.26.

This case presents the question that was expressly reserved in *Container Corp.* This Court's resolution of this important question is necessary to avoid continued state action that conflicts with accepted international commercial practice and prevents the United States "from speaking with one voice when regulating commercial relations with foreign governments" (*Japan Line, Ltd.* v. *County of Los Angeles,* 441 U.S. 434, 451 (1979)).

1. Under the Commerce and Due Process Clauses of the United States Constitution, a State, when imposing an income-based tax, may not tax value earned outside its borders. *Allied-Signal Inc.* v. *Director, Division of Taxation*, 112 S. Ct. 2251, 2255, 2258 (1992). The State may, however, constitutionally tax on an apportioned basis the income earned by a corporation in multiple taxing jurisdictions. *Container Corp.* v. *Franchise Tax Board*, 463 U.S. at 164-165. The income to be apportioned must, however, be related to the business carried on in that State. *Allied Signal, Inc.* v. *Director, Division of Taxation*, 112 S. Ct. at 2263. For a tax imposed on an apportioned basis to satisfy the basic requirements of the Commerce Clause, (i) there must be a substantial nexus between the State and the activity or property taxed, (ii) the activity or property must be fairly apportioned to

the taxing State, (iii) the tax must not discriminate against interstate commerce, and (iv) the tax must be fairly related to the services provided by the State. *Wardair Canada Inc.* v. *Florida Department of Revenue*, 477 U.S. 1, 8 (1986); *Container Corp.* v. *Franchise Tax Board*, 463 U.S. at 165-171. When the state tax affects foreign commerce, two additional questions must be addressed: "first, whether the tax, notwithstanding apportionment, creates a substantial risk of international multiple taxation, and, second, whether the tax prevents the Federal Government from speaking with one voice when regulating commercial relations with foreign governments." *Wardair Canada Inc.* v. *Florida Department of Revenue*, 477 U.S. at 8 (quoting *Japan Line, Ltd.* v. *County of Los Angeles*, 441 U.S. 434, 451 (1979). See also *Container Corp.* v. *Franchise Tax Board*, 463 U.S. at 185-187. "If a state tax contravenes either of these [two additional] precepts, it is unconstitutional under the Commerce Clause." *Japan Line, Ltd.* v. *County of Los Angeles*, 441 U.S. at 451.

The Court observed in *Container Corp.* that "a state tax at variance with federal policy will violate the 'one voice' standard if it *either* implicates foreign policy issues which must be left to the Federal Government *or* violates a clear federal directive." 463 U.S. at 194. The "most obvious foreign policy implication of a state tax is the threat it might pose of offending our foreign trading partners and leading them to retaliate against the Nation as a whole." *Ibid.*

In *Container Corp.*, this Court considered the constitutionality of California's application of the worldwide combined reporting method to determine the income of members of a unitary corporate group controlled by a domestic parent corporation. Noting that the United States had not filed a brief in that case (463 U.S. 195-196 and n.33)[8] and that there was no suggestion that foreign

[8]At the time *Container Corp.* was considered by the Court, there was another case (*Chicago Bridge & Iron Co.* v. *Caterpillar Tractor Co.*, No. 81-349) before the Court that presented virtually the same issue. The United States had submitted an amicus brief and participated in the oral argument in *Chicago Bridge*, taking the position that a similar Illinois tax involving a domestic corporation with foreign subsidiaries violated the Commerce Clause. After argument, the Court ordered

retaliatory acts would stem from California's taxation of domestic parent corporations (*id.* at 195), the Court concluded that California's tax as applied to members of domestic multinational corporations did not seriously threaten the foreign policy of the United States and thus did not violate the Commerce Clause. The Court, however, recognized that the result may be different when the "incidence of the tax" (*ibid.*) falls on a foreign-controlled corporation. See *id.* at 188. The Court therefore expressly reserved judgment as to whether the tax would be constitutional as applied to members of a foreign-controlled corporate group. *Id.* at 189 n.26.

When, as in the present case, the State applies its worldwide combined reporting method to compute the state income tax of members of a foreign unitary corporate group, application of the tax creates an impediment in the relations of the United States with its trading partners and implicates foreign commerce concerns that are the exclusive province of the federal government. As this Court recognized in *Container Corp.*, 463 U.S. at 184-193, the arm's-length standard is the international norm for allocating income among controlled corporations across international boundaries and the method used by the United States for allocating income for federal income tax purposes. The method used by California is at odds with this accepted international practice. California's use of its inconsistent method of taxation has created serious tensions in the federal government's conduct of commercial relations with its trading partners and led to the enactment of retaliatory legislation (Pet. App. F44-F47). See p. 5, *supra*. California's application of its worldwide combined reporting method of taxation to compute the income tax of members of foreign-controlled unitary corporate groups violates the Commerce Clause under this Court's analysis in *Container Corp.* because California's unilateral action departs from an accepted international practice to which the United States adheres and prevents the United States from speaking with one

Chicago Bridge carried over to the next Term, but did not schedule that case for reargument. Instead, it scheduled and heard argument in *Container Corp.* The Members of the Court disagreed as to what position the United States took with respect to *Container Corp.* See 463 U.S. at 195-196 & n.33; *id.* at 204 (Powell, J., dissenting).

voice on this sensitive and important matter of foreign commercial relations. See 463 U.S. at 185-189, 193-196.

2. The California Supreme Court did not test California's method of apportioning income in this case under the analysis set forth in *Container Corp.* because the court concluded (Pet. App. A39) that *Wardair Canada Inc.* v. *Florida Department of Revenue* imposed a new, preliminary hurdle to the taxpayers argument. *Wardair* involved a challenge by a Canadian-based international air carrier to a state sales tax on fuel purchased in Florida for flights operating between Florida and Canada. The Court found "no threat of multiple international taxation * * * since the tax [was] imposed only upon * * * a discrete transaction which occurs within one national jurisdiction only" (477 U.S. at 9). Nor did the Court find any evidence that imposition of the sales tax in that case violated any international norm. *Id.* at 10. To the contrary, the Court concluded that numerous bilateral agreements to which the United States was a party were "understood * * * to permit this sort of taxation" and therefore "show that the Federal Government has affirmatively decided to permit the States to impose these sales taxes on aviation fuel." *Id.* at 12. Finding such "affirmative[ ]" approval of the state tax, the Court found "no need * * * to consider * * * whether, in the absence of these international agreements, the Foreign Commerce Clause would invalidate Florida's tax." *Id.* at 13.

California claims that this case is like *Wardair* because the United States is a party to numerous bilateral tax treaties that set forth agreements with respect to national-level taxation but do not address state or sub-national taxation (Pet. App. A34). California relies specifically on the history of the 1975 tax convention between the United States and the United Kingdom (*id.* at A30-A31). As originally presented to the Senate for advice and consent to ratification, that treaty contained a provision (Article 9(4)) that required sub-national taxation to be consistent with the arm's length standard. See Convention Between United States and United Kingdom for Avoidance of Double Taxation, Dec. 31, 1975, 31 U.S.T. 5670, 5677, T.I.A.S. No. 9682. Although a majority of the Senate voted in favor of the treaty, less than the required two-thirds of the votes were obtained for ratification. 124 Cong. Rec. 18,669-18,670 (1978). In a subsequent vote, however, the treaty was approved subject to a reservation that Article 9(4)) [sic] would not apply "to any political subdivision or local authority of the United States" (*id.* at 18,416). See *id.* at 19,076. The California Supreme Court concluded from this history (Pet. App. A29-A30) that the Senate's action represents "affirmative" approval of the California tax under the analysis of this Court in *Wardair*.

The contrasts between this case and *Wardair* are striking. In *Wardair*, the Court found that numerous treaties had been made that were "understood" by the participants "to permit" state sales taxation to proceed. 477 U.S. at 12. That "understanding" was supported by the fact that there was no international norm precluding that type of state taxation. *Id.* at 10-11. In this case, by contrast, there is a well-established international practice precluding the State's contrary tax system, a practice that the Executive has steadfastly honored and that a majority of the Senate voted to implement. Far from representing acquiescence through silence, this history of Executive and Senate action reflects the thoroughly national character of this issue and the need for federal-level, rather than state-level, disposition of the matter.

Unless this Court concludes that a minority of the Senate can determine the "affirmative" policy of the federal government, it cannot conclude that Senate action on federal tax treaties exhausts the scope of the national power to regulate foreign commerce. The Commerce Clause recognizes that there are matters affecting our foreign commercial relations that inherently require a national solution so that the United States may speak with one voice in its dealings with other Nations. That Congress has not yet crafted a solution to the problem does not mean that the choice of solutions has been left to the separate action of the several States. See *Container Corp.* v. *Franchise Tax Board*, 463 U.S. at 194.[9]

[9]In *Container Corp.*, the Court reviewed much of the same treaty history and legislative proposals considered by the California Supreme Court in this case. See 463 U.S. at 196-197. The Court noted that Congress has "long debated, but has not enacted, legislation designed to regulate state taxation of income." *Id.* at 197 (quoting *Mobil Oil Corp.* v. *Commissioner*, 445 U.S. 425, 448 (1980)). As a result, the Court concluded that there was no "explicit directive" (463 U.S. at 197)

This Court's resolution of the question presented in this case is of great importance because the analysis applied by the California Supreme Court threatens broad impact on the constitutional allocation of authority to the federal government to regulate foreign commerce. Treaties often may stop short of addressing all aspects of commercial relations. Congress may also decline to enact legislative proposals disposing of similar problems. The fact that treaties and legislation have not provided a binding solution does not mean that the States are empowered independently to resolve politically sensitive matters affecting our international commercial relations.

CONCLUSION

If the Court concludes that it has jurisdiction (see Pet. 26-28), the petition for a writ of certiorari should be granted.

Respectfully submitted.

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limiting the State's ability to assess the tax at issue in *Container Corp.* That conclusion, however, did not remove the necessity of also considering whether the State's tax was unconstitutional because it would interfere with the conduct of foreign relations and prevent the federal government from speaking with one voice in the regulation of foreign commerce. See *id.* at 194-196. To the contrary, the Court made clear that *both* inquiries were necessary. See *ibid.*

Appendix L

THIRD READING

SB 671
Alquist(D) et al
9/10/93

SUBJECT: Taxation: unitary and income tax—water's edge: business expenses

SOURCE: The author

DIGEST: This bill permits multinational corporations to use the "water's edge" accounting method to determine its California tax liability without paying an election fee. It also changes the reporting requirements for all corporations. Reduced the State Bank and Corporation deductibility for business meals and entertainment from the current 80 percent of costs to 62 percent.

Senate Floor Amendments of 8/30/93 delete the federal conformity provisions for the personal income tax concerning meals and entertainment. Deletes the club dues denied from both bank and corporation and personal income tax law. Retains the business meals and entertainment expense conformity at a 62 percent level rather than at 50 percent for the State Bank and Corporations Tax.

Assembly Amendments:

1. Modify the unitary method of income apportionment provisions already in the bill.
2. Establish a 6 percent tax credit for manufacturing equipment.
3. Exempt from tax 50 percent of the capital gain realized from the sale of qualified small business stock held for 5 or more years.
4. Reduces from 80 percent to 50 percent the percentage of business meals and entertainment which may be deducted as a business expense.
5. Reduces from 2.5 percent to 1.5 percent the tax rate applied to Subchapter S Corporations.

6. Place a sunset date on sales tax exemptions for space flight material used in a launch at Vandenberg Air Force Base of January 1, 2004.
7. Make the Research and Development credit permanent by deleting the January 1, 1998 sunset date.

For details of each one of the above, see attached Senate Revenue and Taxation Committee analysis.

SUPPORT: (Verified 8/25/93)

California Manufacturers Association
California Chamber of Commerce
California Taxpayers Association
Franchise Tax Board

ARGUMENTS IN SUPPORT: Proponents state, "SB 671 is intended to make changes to California's method of taxing corporate income. Changes are required by September 10 to improve California's business climate and avoid an international tax war.

"California companies and those engaged in business here wish to avoid retaliation by the foreign governments. The provisions provided in SB 671, as amended, is an acceptable resolution for the business community.

"A broad coalition of business groups supports this course of action. Also, the Franchise Tax Board has adopted a very similar position.

"If these changes are made, the associations support a revenue neutral bill using revenue raised from adopting recent federal tax changes. If this legislation is approved by September 10, we believe it will meet the needs of our foreign trading partners for a more equitable system of taxation."

The business community supports the other provisions which they believe will simulate [sic] economic growth.

SB 671—Alquist
(amended 9/9/93)

SUBJECT: Personal Income Tax, Bank & Corporation Tax, Sales Taxes: Unitary method of apportionment, 6% manufacturing credit, reduction in Sub S rate, Exemption for start-up manufacturers and space launches from Vandenburg [sic], conforms with business meal deductions and small business incentives, changes research & development base and removes sunset on credit

AS PASSED BY THE SENATE SB 671:

—deleted the requirement that firms making the water's-edge election file a domestic disclosure spreadsheet

—removed the FTB's authority to disregard a water's edge election

—repealed the election fee for a water's-edge election

—reduced the business meals deduction for corporate taxpayers from 80% of cost to 62% of cost

AS PASSED BY THE ASSEMBLY SB 671 contains the following provisions:

1. *Unitary method of income apportionment.* The bill deletes the requirement to file the domestic disclosure spreadsheet for firms making the water's-edge eledtion [sic] and replaces this requirement with a minimal reporting requirement for firms with over $200 million in assets.

It eliminates FTB's authority to "disregard' a water's-edge election. In place of this authority, the bill requires taxpayers to provide specified audit information. Taxpayers failing to provide that information would be subject to a substantial penalty.

SB 671 repeals the election fee for taxpayers filing their return on a water's edge-basis. The repeal is effective for income years beginning on or after January 1, 1994.

2. *Credit for manufacturing equipment.* SB 671 establishes a tax credit equal to 6% of qualified manufacturing equipment

placed in service after January 1, 1994. The credit could be claimed beginning with the 1995 tax year.

The credit would be available for property used primarily in manufacturing, research and development, or the repair and maintenance of qualified equipment. Qualified equipment is depreciable property as defined in Section 1245 of the Internal Revenue Code. However, the credit could be claimed for special purpose buildings and foundations that do not meet the Section 1245 criteria if they are used by biotech firms and manufacturers of office, computing, and accounting machines as well as manufacturers of electronic components and accessories.

The credit could be claimed against both the regular tax and the alternative minimum tax. Unused credits could be carried forward to offset future tax liabilities for up to 8 years (10 years for "small" firms.)

The credit would sunset January 1, 2001, if manufacturing employment—other than aerospace employment—does not increase by 100,000 jobs during the period between January 1, 1994 and January 1, 2001.

Instead of this credit, a start-up firm has the option of a 6% sales tax exemption on manufacturing equipment during its first three years of operations.

3. *Small business stock capital gains.* This bill exempts from taxation 50% of the capital gain realized from the sale of qualified small business stock held for 5 or more years. For a stock to be eligible for this income exclusion, it must meet the following criteria:

—The stock must be originally issued after August 10, 1993 and before December 31, 1998 by a company doing business in California which has less than $50 million in gross assets. At least 80% of the qualifying company's payroll must be attributable to employment located in California.

—The issuing company cannot be engaged primarily in the performance of specified services including: health, law, engineering, accounting, performing arts, or consulting. Banking, insurance, farming, oil and gas extraction, hotel, and restaurant business are also ineligible.

4. *Business Meals.* SB 671 reduces from 80% to 50% the percentage of business meals and entertainment which may be deducted as a business expense. This changes [sic] is consistent with recent federal tax law changes.

5. *Subchapter S.* This bill reduces from 2.5% to 1.5% the tax rate applied to Subchapter S corporations.

6. *Space Flight Material.* Space flight material used in a launch at Vandenburg [sic] Air Force Base would be exempt from state and local taxes. This exemption sunsets January 1, 2004.

7. *Research and Development Credit.* This bill makes the credit permanent by deleting the January 1, 1998 sunset date. In addition, it replaces the state's "three-year rolling average" method of calculating the crredit [sic] with the federal "fixed base" method.

FISCAL EFFECT: (Franchise Tax Board)

	93–94	94–95	95–96	96–97	97–98	98–99	99–00
Unitary	$–15	–60	–75	–80	–80	–80	–80
Investment Credit		–125	–406	–373	–375	–375	–375
Business Meals	+40	+140	+150	+160	+160	+160	+160
Sub S Reduction	–30	–70	–78	–80	–80	–80	–80
Sm. Bus. Investment						–15	–26
Research & Devt	–22	–45	–50	–60	–60	–200	–200
Space Launches		–7	–15	–15	–15	–15	–15
	$–27	–167	–474	–448	–450	–605	–616

1. Unitary Method of Income Apportionment

EXISTING LAW (Bank and Corporation Franchise Tax Law) imposes a tax on corporations doing business in California. The tax is technically a "franchise tax" on the privilege of doing business as a corporation in California, and is "measured by" the amount of income derived from California activities; the tax is imposed at a rate of 9.3%, with a minimum tax of $800.

If a corporation is engaged in a business which is conducted both within and without California, that business is considered a "unitary business," and the amount of income subject to tax in California is determined by a formula based on the average percentage of payroll, property and sales in California as com-

pared with total payroll, property and sales for the entire business, nationwide or worldwide. This is known as "formulary apportionment."

> For example, if the corporation's California payroll, property and sales are 20%, 25% and 30%, respectively, of the payroll, property and sales for the entire business, worldwide, then 25% (the average of 20, 25 and 30) of the net income of the business would be subject to California's 9.3% tax rate.

If a commonly owned or controlled group of corporations conducts a unitary business both within and without California, then the group must file a "combined report" with FTB which includes the California payroll, property and sales factors for all of the corporations combined. The share of the unitary group's income which is subject to California's 9.3% tax rate is based on each taxpayer's California payroll, property and sales as a percentage of the group's nationwide or worldwide payroll, property and sales as shown on the group's combined report. When foreign operations are included in a combined report, it is called "worldwide combination."

Since 1988, an alternative method has been available for determining California's share of a worldwide unitary business—the so-called "water's edge" method. Under water's edge (enacted by SB 85 (Alquist—1986)), a worldwide group of commonly owned or controlled corporations conducting a unitary business may elect to have formulary apportionment apply only with respect to those operations which are within the "water's edge." In other words, only those corporate affiliates which are defined to be within the United States water's edge must be included in the combined report; foreign affiliates are not included in the report.

In order to compute tax on a water's edge basis, the members of the unitary group must agree to pay an election fee equal to 0.03% (three hundredths of one percent) of the sum of their 1986 payroll, 1986 property, and current-year sales in California, reduced by increases in investment and payroll since 1986. The election period is a minimum of five years.

In addition, corporate groups electing water's edge must agree to provide FTB, every three years, with a "domestic disclosure

spreadsheet" showing the income and tax liability reported to each state, the method of apportioning income to each other state, a list of affiliated corporations, and other information as required by FTB regulation.

Finally, if a taxpayer electing water's edge willfully refuses to file the spreadsheet or other necessary audit information, or if FTB determines that evasion of taxes cannot be prevented with the audit tools available, then the FTB may "disregard" (or revoke) the water's edge election, thus throwing the taxpayer back under the worldwide combination method.

Note that the election fee, the domestic disclosure spreadsheet, and FTB's ability to disregard the election have been the subject of much dispute since passage of SB 85 in 1986. Many taxpayers, most notably British corporations, have strenuously objected to these features of our water's edge method, arguing that water's edge, and the accompanying "direct accounting" method, conform with international standards of taxation, and that California's divergence from these standards is offensive to them. (Note, however, that a number of corporations continue to prefer filing under the old worldwide combination method, since their tax liability is lower under that method.)

THIS BILL would *repeal the current election fee* for those desiring to use the water's edge method, and would extend the current five-year contract period to seven years.

The bill would also *repeal the present domestic disclosure spreadsheet* requirement for companies electing water's edge, and would substitute an information return containing a list of the corporation's affiliates. Whereas the current spreadsheet is required of all large corporations which elect water's edge, the proposed list-of-affiliates requirement would apply to all large corporations.

FTB believes that the list of affiliates is the most useful of the information currently required as part of the spreadsheet; they also believe that this information is readily available, unlike much of the presently required spreadsheet information. The information return would be due in the year of first election to water's edge, and would subsequently be due every three years.

And the bill would *remove FTB's ability to disregard the water's edge election*. In place of the disregard power the bill would require electing taxpayers to maintain and provide on request information necessary to (1) determine the amount of income attributable to the state, (2) classify income as business or nonbusiness income, (3) determine unitary apportionment factors for use within the water's edge, and (4) make audits of attribution of income to the U.S. and foreign countries under certain federal provisions. Failure to comply would result in a substantial penalty (in lieu of the current disregard power): $10,000 for each taxable year for which information is not made available, and another $10,000 for each 30 days (after an initial 90 days) if the taxpayer continues to refuse to provide information. (This penalty is adopted from a similar federal information requirement. It would be limited to a maximum of $50,000 until detailed regulations are adopted by the FTB.) The bill further provides that if information is not provided to FTB, then the income apportioned to California, the classification of business vs. nonbusiness income, the apportionment factors, and certain other information will be determined for the taxpayer by FTB. FTB indicates that the required information is necessary in order to properly audit the complex relationship between the water's edge group and affiliated corporations beyond the water's edge.

The bill is intended to accomplish two objectives. First, it is intended to respond to the British Government's threat of retaliation against states which require multinationals to use the worldwide unitary method by revoking a tax credit previously granted to companies which do business both in Britain and in California. In 1985, the British Parliament added a clause to the Finance Bill which would allow the Government to retaliate unless by an unspecified date the worldwide unitary method had been repealed by the states then using it. This May, in response to the new Clinton Administration's apparent reversal of federal position on the *Barclays* case (see below), Chancellor of the Exchequer Lamont announced that "the Government will have to take retaliatory measures in relation to United States based companies if there is not a satisfactory resolution of the unitary tax problem by the end of the year." Although direct communications with British Government representatives have been few, the best information now available is that a three-part bill (elimination of

the election fee, reform of the spreadsheet requirements and repeal of FTB's disregard power) would be sufficient to avoid retaliation. (It should be noted that the total amount associated with retaliation is well over $1 billion in cost to U.S.-based corporations.)

Second, it is intended that, by removing the threat of British retaliation, the bill would make it possible for the Clinton Administration to file a neutral brief with the Supreme Court with respect to whether the Court should take up the *Barclays* case. Although the Supreme Court has blessed the worldwide unitary method in the past, most notably in the 1983 *Container Corp. v. Franchise Tax Board*, the Court has remained silent on commerce clause questions relating to whether a state could require a foreign-based multinational to file on a worldwide combined basis. The prior Administration had filed a brief with the Supreme Court on behalf of Barclays. But as a presidential candidate, Clinton assured California officials that he would side with the states on the issue.

The threat of retaliation, however, naturally caused a seriously awkward situation for the new Administration, and Treasury representatives have requested that California's law be modified to remove the threat. California officials have been assured that if our law is changed in a manner which will remove the threat, then a neutral brief (to the effect that the Administration does not advise the Court to take up the *Barclays* case) would be filed. The deadline for the Solicitor General to act is apparently September 10.

If the Supreme Court takes up the *Barclays* case and decides in favor of Barclays, the direct result will be that California would owe some $500 million in refunds to taxpayers, and we would NOT collect some $350 million in pending assessments, for a total of about $900 million in real costs and opportunity cost. It is likely that if we are unable to require worldwide combination for foreign-based multinationals, we would be unable to so tax domestic-based multinationals as well. We would then lose an additional $1.2 billion in refund claims and another $1.9 billion in cancellation of pending assessments, for a grand total of $4 billion. (This casts the $60 million annual cost of repealing the election fee in a new perspective.)

2. Credit for Manufacturing Equipment

This bill provides a credit equal to 6% of the cost of eligible manufacturing equipment used by manufacturers. Eligible equipment is depreciable property as defined in Section 1245 of the Internal Revenue Code. Eligible equipment also includes special purpose buildings and foundations used by biotech firms, manufacturers of computers, office and accounting machines, electronic components and accessories.

The credit may be used to reduce regular tax liability or alternative minimum tax liability. Unused credits may be carried forward for 8 years. "Small firms" may carry forward these credits 10 years. "Small firms" are defined as firms which meet one of the following criteria:

—has gross receipts of less than $50 million

—has net assets of less than $50 million

—has a total credit of less than $1 million. This is equal to about $16.7 million in purchases.

This credit is effective for purchases made on or after January 1, 1994 and may be claimed beginning with the 1995 tax year. This means that taxpayers may claim a credit for purchases made both in 1994 and 1995 on their 1995 returns.

This exemption sunsets January 1, 2001 if manufacturing jobs—other than aerospace jobs—do not increase by at least 100,000 during the period between January 1, 1994 and January 1, 2000.

Exemption for New Manufacturers

In lieu of the credit for manufacturing equipment, new manufacturers may claim an exemption from the 6% state portion of the sales tax. New manufacturers are defined as manufacturers in the 2000-3999 SIC Codes in the first 3 years of operation who first commence business on or after January 1, 1994.

Property eligible for the exemption is broader than property eligible for the credit and "includes, but is not limited to"

—machinery & equipment

—computers or other devices used to regulate machiner [sic]

—replacement parts with a useful life of 1 year or more

—property used in pollution control

—special purpose buildings used in manufacturing

—fuels used in manufacturing

The following kinds of property are not eligible for the exemption: furniture, inventory, equipment used to store finished products (e.g., shelving), buildings used as warehouses or property with a useful life of less than one year.

Manufacturers must file an exemption with the retailer at the time of purchase. Manufacturers would be required to pay the sales tax on equipment for which they had claimed an exemption if they remove the property from California within one year or if they use the property for a non-exempt purpose—e.g., purchasing a computer and claiming that it will be used for manufacturing then later using it for payroll and accounting.

This exemption sunsets January 1, 2001 if manufacturing jobs—other than aerospace jobs—do not increase by at least 100,000 during the period between January 1, 1994 and January 1, 2000.

3. Small Business Stock Capital Gains

This bill conforms to the recently enacted federal tax provisions relating to small business investment, but only for investment in small California businesses.

Exclusion from gain. It excludes from income subject to tax 50% of the gain on the sale of certain small business stock if the stock is held for five or more years.

The total amount of gain which can be excluded is equal to the greater of:

—10 times the taxpayer's basis in the stock. (Purchase price is generally the basis)

or

—$10 million in gain. The $10 million limitation is applied on a shareholder by shareholder basis.

One half of any excluded gain is treated as an item of preference for purposes of calculating the alternative minimum tax.

Eligible stock. Stock in qualified small businesses, issued on or after August 10, 1993 and prior to December 31, 1998 at the original issuance of the stock in exchange for money, property other than stock, or compensation for services is eligible for the exclusion. (Note: August 10, 1993 is the date the federal tax bill went into effect.)

Qualified small business. To be eligible for the exclusion, the taxpayer must purchase eligible stock in a business which:

—is a C corporation

—has gross assets of $50 million or less

—uses 80% or more of its gross assets in the active conduct of a trade or business in California

—employs at least 80% of its payroll in California

—holds 10% or less of its assets in real property or stock

Investment in the following kinds of businesses would not qualify for the exclusion:

—Domestic international sales corporations (DISC), regulated investment companies (RIC), real estate investment trust (REIT), real estate mortgage investment conduit (REMIC), possessions corporations (Section 936)

—Performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of the trade or business is the skill or reputation of one or more of its employees

—Banking, insurance, leasing, financing, investing, farming, extraction, operation of a hotel, motel, restaurant, or similar business

Partnerships and other restrictions. Gain from the sale of qualified small business stock that is purchased by a partnership,

S corporation, or RIC qualifies for the exclusion if the stock is held by the entity for the minimum 5 years and the partner or shareholder of the entity was a partner or shareholder from the time the stock was acquired until its sale. A partner's or shareholder's ability to exclude gain is limited by the partner's or shareholder's interest in the entity at the time the stock was purchased.

A partnership may distribute qualified small business stock to its partners provided a partner was a member of the partnership when the stock was acquired.

If qualified small business stock is transferred to a partnership and the partnership sells the stock, the gain on the sale will not qualify for the exclusion provided by AB 44.

When qualified small business stock is transferred by gift or death, the recipient is treated as owning the stock in the same manner as the donor.

Stock acquired through the exercise of options, warrants or conversions of convertible debt is treated as acquired at original issue.

A taxpayer is not permitted to exclude gain from the sale of qualified small business stock if the taxpayer held a short position in that stock during the 5-year holding period.

This bill requires that the Legislative Analyst's Office study the effectiveness of the capital gains exclusion and report to the Legislature by December 31, 1996. The study will include:

—the effect on investor decisions and amount of additional investment and jobs which occur

—a listing by industry of investments made

—estimated state and local fiscal impact

4. Business Meals

SB 671 conforms to 1993 federal tax changes by reducing the amount businesses can deduct for business meals and entertainment from 80% of cost to 50% of cost.

5. Subchapter S

Current law conforms with federal provisions allowing certain "small business corporations" (defined as corporations with 35 or fewer shareholders, all of whom must be human beings, and only one class of stock) to be treated as partnerships for tax purposes. Our law diverges from federal law in that there is no federal tax at the corporate level for S corporations, whereas California charges a 2.5% tax on net income of S corporations (compared with the 9.3% tax on ordinary corporations).

The bill would reduce the 2.5% tax on S corporations to 1.5%.

6. Space Flight Material

This bill would exempt property from both the state and local share of the sales tax if it is used in a space flight originating at Vandenburg [sic] Air Force Base from January 1, 1994 through December 31, 2003.

Eligible property includes, but is not limited to:

—orbital space facilities

—space propulsion systems

—space vehicles

—satellites

—space stations

—any component parts

"Material that is not intended to be launched into space" is not exempt.

This exemption would be granted even if the launch is cancelled, postponed or fails.

7. Research and Development Credit

EXISTING LAW provides a tax credit for qualified research and development (R&D) expenses incurred by businesses. The credit is generally 8 percent of the increase in research and development expenses above the *average of the prior three years' R&D expenditures.* The minimum base is 50% of the total

research and development expense for the current taxable year. In the case of "basic research" the credit is 12 percent. For start-up companies with fewer than three taxable years, a fixed-base method is used—research expenditures qualify for the credit to the extent that they exceed 3% of a firm's California gross receipts. The credit is currently scheduled to sunset at the end of 1997.

Except for start-ups, California does not conform to the federal base period computation. Federal law provides that research expenditures in excess of a fixed base amount qualify for the credit. The base amount is determined by (1) calculating the ratio of research expenditures to gross receipts for a firm's 1984 through 1988 income years (the "fixed base percentage"); and (2) multiplying that ratio by the firm's average gross receipts during the past four years.

THIS BILL deletes the current 1997 sunset for the research and development credit, and substitutes the federal fixed base period for the present "rolling" three-year average base period. The bill also conforms with the new federal definition of start-up companies as.

This provision is part of the Assembly Democratic Economic Prosperity Team (Adept) package of business incentives. It is intended to be part of a coordinated attempt to stimulate more California economic development and make it possible for California to compete more effectively with other states in retaining and attracting business. This part of the package is "aimed at making capital more available for California's economic development.

Consultants: Martin Helmke & Anne Maitland
Revised 9-17-93

Appendix M

CHAPTER 601 1990 REG. SESSION
SEC. 2

SEC. 2. Subject to the provisions of Section 25111 of the Revenue and Taxation Code and Chapter 22 (commencing with Section 26071) of Part 11 of Division 2 of the Revenue and Taxation Code, in the event of a final appellate level determination by a California or federal court that the application of the worldwide combined report method or the requirement that amounts be paid pursuant to Section 25115 of the Revenue and Taxation Code is unconstitutional, amounts paid pursuant to Section 25115 of the Revenue and Taxation Code for income years beginning on or after January 1, 1988, shall, to the extent ordered by the court or as otherwise provided in Article 1.5 (commencing with Section 25110) of Chapter 17 of Part 11 of Division 2 of the Revenue and Taxation Code and regulations thereunder as of the effective date of this act, be refunded, with interest as provided in Section 26080 of the Revenue and Taxation Code, from funds in the California Unitary Fund, which is hereby appropriated to the Franchise Tax Board for that purpose.

In the event that there are insufficient funds in the California Unitary Fund for those refunds, refunds of amounts paid pursuant to Section 25115 of the Revenue and Taxation Code shall be paid from the General Fund. There is hereby appropriated from the General Fund to the Franchise Tax Board an amount necessary to pay the balance of those refunds.

Appendix N

13 May 1993

UNITARY TAXATION

The Chancellor of the Exchequer, the Rt. Hon Norman Lamont MP, today announced that the Government will have to take retaliatory measures in relation to United States based companies if there is not a satisfactory resolution of the unitary tax problem by the end of the year.

In reply to a Parliamentary Question, the Chancellor said:

> "US Treasury Secretary Bentsen has explained the US Administration's position. He and his colleagues recognise the importance the British Government attaches to this issue, the strength of feeling in the UK and the risk of retaliatory action by the UK if a satisfactory solution is not forthcoming. He has assured me that the Administration are very keen to find a solution to this problem that is acceptable. I have said that the Government is ready to discuss how an acceptable solution could best be achieved. But I have informed him that the Government will have to take retaliatory measures in relation to United States based companies if there is not a satisfactory resolution of the problem of the internationally-opposed unitary tax on foreign-owned companies in California by the end of this year. Meanwhile, I have instructed the Inland Revenue to obtain information from California-based companies in the UK, on the probable impact of such retaliatory measures."

Appendix O

Translation BMF—AG St—SH Bonn, June 1993

Resolution of the Finance Committee of the German Bundestag concerning unitary taxation in the State of California

The Finance Committee of the German Bundestag has today discussed the problem of unitary taxation as applied in the State of California to the cross-border apportionment of profits between associated enterprises.

The Finance Committee notes that this method of taxation used by the State of California is based on a flat-rate allocation of profits that is inconsistent with the internationally accepted arm's-length principle, that such allocation of profits can result in substantial double taxation and that it imposes disproportionate burdens on enterprises in discharging their tax filing obligations. In the opinion of the Committee, a "water's-edge" rule under which enterprises operating on an international basis can gain exemption from worldwide unitary taxation of their income only on payment of a large fee is also in conflict with the principles of taxation as agreed in the German-American Convention for the Avoidance of Double Taxation.

The Finance Committee notes with regret the departure of the new U.S. administration from the course followed by former U.S. administrations for more than 20 years. The rejection of unitary taxation has always been and still is both a reflection of mutually agreed positions and a necessary means of ensuring, among other things, that economic relations between the United States of America and the Federal Republic of Germany continue to function smoothly and without disruption.

The Finance Committee calls upon the new U.S. administration to return to the common approach adopted by all other OECD countries and to urge the State of California to relinquish, in the interest of avoiding disruptions of international trade, the system of unitary taxation that is rejected by all other industrialised nations.

The Finance Committee requests the German government to take immediate steps to consider the application of retaliatory mea-

sures should it prove impossible to achieve a satisfactory solution to the problem of unitary taxation within a reasonable period of time. In making this request, the Finance Committee proceeds on the assumption that it will be possible to reach a statisfactory [sic] solution by the end of 1993.

Appendix P

15 September 1993

UNITARY TAXATION

Commenting today on the news that the California State Legislature has reformed its unitary tax laws, the Chancellor of the Exchequer, The Rt. Hon. Kenneth Clarke QC MP, said:

> "I am greatly encouraged to learn that California has passed legislation to modify its unitary tax law. This development is a vindication of the Government's decision to set a definite time limit for the implementation of retaliatory measures. But for the Government's action it is clear that there would have been no progress in California. The approach that California has now adopted has been designed to bring to an end the problem of unitary tax for UK owned companies in California. However, given the defects that remain in the law, it will be important to ensure that the spirit of the new approach is followed in the detailed regulations and in the practical application of the law. The UK will therefore defer retaliatory action and will retaliate only if it is found that the legislation is being applied in a way which exposes UK owned companies to damage from taxation that is inconsistent with the arm's length principle. I am informing Secretary Bentsen accordingly.
>
> While the legislation in California is a significant step forward, on its own it does not provide a complete solution to the unitary tax problem. For a complete solution it will be necessary to have the internationally accepted arm's length principle endorsed, on a permanent basis, as the only valid method of taxing foreign companies in any State. Success for the Barclays case in the Supreme Court would achieve this. The Government will continue strongly to support Barclays' case. I hope it will succeed. If it does not, the UK will have to retain its retaliatory powers in reserve as a barrier against the possibility that States might damage UK owned companies by the imposition of unitary taxation at some time in the future."

Appendix Q

EMBASSY OF BELGIUM

3320 Garfield Street, N.W.
Washington, D.C. 20005

Washington, September 23, 1993

The Honorable
Warren Christopher
Secretary of State
Washington, D.C. 20520

Dear Mr. Secretary,

We have the honor to convey to you the attached note on unitary taxation on behalf of the Governments of the Member States of the European Community and the Commission of the European Communities.

We avail ourselves of this opportunity to renew to you the assurances of our highest consideration.

Juan Cassiers
Ambassador of Belgium
EC-Presidency

Andreas van Agt
Ambassador of the
Delegation of the Commission
of the European Communities

UNITARY TAXATION

1. The Member States of the European Community and the European Commission have the honour to refer to their note of 26 March 1993 in which they expressed their strong opposition to worldwide unitary taxation and urged the United States Government to support the Barclays petition for certiorari to the United States Supreme Court. The Member States, together with eight other major trading partners of the United States, subsequently supported the Barclays petition in an amicus curiae brief dated 22 April 1993.

2. The Member States and the European Commission note that the State of California has since passed legislation to modify its unitary tax law. While this legislation is an improvement, the Member States and the European Commission do not consider that the unitary tax problem is solved. Worldwide unitary taxation, which is contrary to the internationally agreed arm's length principle, is still the basis of the tax system in California. A complete solution will require the arm's length principle to be established as the only legitimate basis of taxing foreign companies in any state.

3. The Member States and the European Commission therefore continue strongly to urge the United States Government to support the Barclays petition for certiorari to the United States Supreme Court.